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Supreme Court of the United States

OCTOBER TERM, 1964.

No. 620.

REAL ESTATE INVESTMENT TRUST OF AMERICA ET AL.,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT.

REPLY BRIEF FOR THE PETITIONERS.

Argument.

In his brief on the petition in this case respondent has taken a position in accord with the view of the Second Circuit expressed in *Lubin* v. *Commissioner of Internal Revenue*, 335 F. 2d 209 (Pet. 49-58), that the tax treatment of the gain realized on the sale of a debt obligation previously acquired at a discount depends upon the substance of the underlying transaction which gave rise to the obligation. An economic analysis of the particular transaction might lead to the conclusion that the portion of the indebtedness representing the discount should be characterized as "in-

terest," and therefore be treated, when realized, as ordinary income, or that such portion should be characterized as something other than "interest," and therefore be treated as capital gain (Brief 6).[1]

Respondent contends, however, that the decision below is not in conflict with *Lubin*. He contends that the Tax Court in the instant case found that the discount involved represented "interest," and that the reviewing court affirmed the Tax Court specifically on the basis of that finding.

The Tax Court in the instant case and in the *Lubin* case made only the simple and unelaborated finding that the discounts in question represented "interest."

As this Court said recently in an analogous situation, "there comes a point where findings become so sparse and conclusory as to give no revelation of what the [trier of fact's] concept of the determining facts and legal standard may be." *Commissioner of Internal Revenue* v. *Duberstein*, 363 U.S. 278, 292 (1960). The unelaborated findings of ultimate fact made by the Tax Court both here and in *Lubin* afforded the reviewing courts not the semblance of an idea of how the trier of fact approached its task.[2]

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[1] Respondent does not suggest, nor has the suggestion been made below, that, if the discount in this case should be characterized as something other than "interest," petitioner is not entitled to treat the gain on the sale of the note as capital gain.

[2] The statement of this Court in *Deputy* v. *du Pont*, 308 U.S. 488, 498 (1940), that "interest on indebtedness means compensation for the use or forbearance of money" is, as the Second Circuit pointed out in *Lubin*, "not dispositive of the issue before us, nor can it be." Surely, the Tax Court could not have applied any standard based on this Court's definition of interest in *Old Colony Railroad Co.* v. *Commissioner of Internal Revenue*, 284 U.S. 552, 561 (1932): "[I]nterest means what is usually called interest by those who pay and those who receive the amount so denominated in bond and coupon . . . the words of the statute . . . do not refer to some esoteric concept derived from subtle and theoretic analysis."

For all that appears, the Tax Court regarded as conclusive in each case the simple fact that, in consideration of an advance of money, a person undertook to pay at a specified time in the future a greater amount than that which he received. Whether this concept of the relevant standard involves a finding of fact, as respondent contends, or amounts to a rule of law, as we suggest, is of little consequence. For, if that was the standard applied, the decision below is plainly in direct conflict with the decision of the Second Circuit in *Lubin*.

If the Tax Court applied any other standard in making its findings below and in the *Lubin* case, we cannot discern it from its opinion in either case. Nor can we imagine what concept of the determining facts and legal standard (other than the one suggested *supra*) the Court of Appeals had in mind when it reviewed the Tax Court's finding below. It said: "Original issue discount is a form of interest or compensation for the use of money" (Pet. 16). The fact that the obligation in the instant case bore a fair rate of interest apart from the discount is "of little significance" (Pet. 17).

In *Lubin* the Court of Appeals for the Second Circuit reversed the Tax Court, not, we may add, because the Tax Court's findings were "clearly erroneous," but rather because the Second Circuit felt that the Tax Court had applied an erroneous rule of law.[3]

We recognize that, given the statutory framework, the problem of determining what is and what is not interest is one which does not lend itself to a definite statement that would produce a talisman for the solution of all cases. Yet

[3] Since "the evidence relating to the substance of the transaction afforded no basis upon which the Tax Court could have concluded that [the] profits were interest payments" (Pet. 58), the case was not remanded to the Tax Court but the decision was simply reversed.

surely some guides and standards could be developed and laid down in cases like these, which, after all, involve undisputed basic facts.

A large borrower of unquestionable solvency can borrow money at a price which reflects the range of what the market recognizes as interest. A borrower of dubious solvency, offering as the hope of repayment only the speculative potential of a favorable change in his financial condition, cannot.

If such a borrower agrees to repay within four and one-half years an amount equal to the sum of (1) the amount borrowed, (2) interest on the amount borrowed at an effective rate of 8% per annum payable quarterly, and (3) an additional amount equal to 60% of the amount borrowed, surely the entire 60% additional amount cannot arbitrarily be categorized as an interest equivalent. Some portion, at least, represents the potential speculative profit of a legitimate capitalist and cannot properly be categorized as additional consideration for the use of the money borrowed.

Respondent apparently does not disagree. He says, "If, for example, *A* agreed to pay *B* 20% interest on a loan only because *B* was his son, some part of the payments ought obviously to be treated as a gift notwithstanding the 'interest' label" (Brief 5-6). Presumably respondent is saying that a charge at the rate of $20 for the use of $100 for a year exceeds anything within the range of what the market recognizes as interest. Yet, if the discounts in question here and in the *Lubin* case are to be treated as "interest," the total "interest" charge on the money advanced would be at a rate of simple interest in excess of 20% per annum in the instant case,[4] and in *Lubin* at a rate in excess of 75% per annum (Pet. 56).

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[4] The $1 million note issued to petitioner bore interest at a stated annual rate of 4% of the unpaid principal balance, or an effective rate

Conclusion.

The *Dixon* and *Midland-Ross* cases (Nos. 486 and 628) do not present the entire conflict among the Circuits on the question presented. For the approach of the Court of Appeals for the First Circuit in the instant case is plainly in conflict with the approach taken by the Court of Appeals for the Second Circuit in *Dixon* and *Lubin*. If the conflict on the question presented in the *Dixon* and *Midland-Ross* cases is resolved in favor of the view of the Second Circuit in *Dixon*, a clarification of the problem typified by the instant case and the *Lubin* case will become necessary. The problem is of considerable importance in the administration of a revenue system which provides different rates of taxation for ordinary income and for capital gain and which allows as a deduction from the tax base "all interest paid or accrued . . . on indebtedness." For these reasons the petition for a writ of certiorari should be granted, and the grant of certiorari should not be limited to the question presented by the *Dixon* and *Midland-Ross* cases.

Respectfully submitted,

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of 8% per annum of the $500,000 advanced by petitioner. In addition, since the debtor was obligated to pay the entire obligation within four and one-half years, and since petitioner acquired the note at a $300,000 discount, petitioner was entitled to receive an additional amount equal to 60% of the amount advanced, which, if stated in terms of simple interest on the amount advanced, would be equivalent to additional interest at a rate in excess of 12% per annum.